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No. 86-422

IN THE

Supreme Court of the United States

OCTOBER TERM, 1986

DAVID CARPENTER, KENNETH P. FELIS, and R. FOSTER WINANS,
Petitioners,

v.

UNITED STATES OF AMERICA,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

BRIEF OF THE REPORTERS COMMITTEE FOR FREEDOM OF THE PRESS, THE NATIONAL ASSOCIATION OF BROADCASTERS, THE NEWSLETTER ASSOCIATION, THE NEW YORK FINANCIAL WRITERS ASSOCIATION, THE MEDIA INSTITUTE, THE NEWSPAPER GUILD, THE RADIO-TELEVISION NEWS DIRECTORS ASSOCIATION, THE AMERICAN SOCIETY OF MAGAZINE EDITORS, THE SOCIETY OF AMERICAN BUSINESS EDITORS AND WRITERS, AND THE ASSOCIATED PRESS MANAGING EDITORS AS *AMICI CURIAE* IN SUPPORT OF PETITIONERS

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QUESTIONS PRESENTED

Amici Curiae will address the following questions:

1. Whether a reporter for a newspaper can be prosecuted under the federal securities laws even though the reporter, as a pure market "outsider," owed no fiduciary duty to any market participant, did not trade on the basis of any "inside" corporate information, and did not injure any market participant.

2. Whether Rule 10b-5 should be construed narrowly to avoid imposing vague disclosure requirements on reporters which would interfere with the editorial processes of the print and broadcast media protected by the First Amendment.

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INTEREST OF *AMICI CURIAE*

The Reporters Committee for Freedom of the Press ("Reporters Committee") is a voluntary association of reporters and news editors from the print and broadcast media. It serves as a legal defense and research fund dedicated to protecting the freedom of information rights and editorial freedom of the press guaranteed by the First Amendment. Since its founding in 1970, the Reporters Committee has taken an active role in virtually every major case concerning press freedoms before the United States Supreme Court.

The National Association of Broadcasters ("NAB"), organized in 1922, is a nonprofit, incorporated association of more than 4,800 radio stations, 950 television stations, and the major commercial broadcast networks. One of NAB's primary concerns is maintaining the vitality of the First Amendment guarantee of freedom of the press.

The New York Financial Writers Association is made up of over 350 reporters and editors in the New York metropolitan area who are associated with national and local print and electronic media. Founded in 1938, the Association is dedicated to upholding the professional standards of business and financial journalists and encouraging education in this specialized field.

The Newspaper Guild is a trade union representing some 40,000 employees of newspapers, magazines, wire services and related enterprises in the United States, Canada and Puerto Rico. It has been actively involved in protecting the First Amendment rights of its members and all Americans.

The Radio-Television News Directors Association is a professional association of electronic journalists. The Association has over 2,500 members who gather, edit and disseminate news and other public affairs information carried by the national networks, local radio and tele-

vision broadcast stations and cable television systems throughout the nation.

The American Society of Magazine Editors has 450 members who are chief and senior editors of consumer, trade and farm magazines across the United States. The Media Institute is a nonprofit research organization which has published numerous reports on foreign and domestic communications policy and studies on broadcast coverage of economic news. The Newsletter Association is an international trade association of 850 publishers of 2,500 newsletters and other specialized services, which provide financial and other types of information.

The Society of American Business Editors and Writers is made up of more than three hundred business editors and writers of newspapers, periodicals, business journals, and radio and television programs across the nation. The Society was founded in 1962 and exists to promote the development of business news reporting and the highest professional standards of economic journalism.

The Associated Press Managing Editors include more than 600 editors of newspaper members of the Associated Press, which gathers news worldwide for dissemination to 1,350 newspapers and 3,300 broadcast stations in the United States.

Amici's membership includes reporters and editors from the field of financial journalism. Their professional interests are directly affected by the theory of the government's prosecution in this case, which asserts that Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5, provide a permissible vehicle for enforcing vague and undefined duties of journalists to disclose to their editors and publishers any use of their employer's confidential information that may have some effect on a securities transaction which benefits the reporter. Put another way, the prosecution in this case at-

tempts to criminalize journalistic codes of ethics and, by using the employment relationship to define and establish a crime, to intrude improperly on the editorial process. *Amici* recognize that the government's prosecution of a pure market "outsider" does not uniquely disadvantage the interests of the press and broadcast media. The implications of this decision extend far beyond its impact on the editorial process. Nevertheless, the decision below, which grants the federal government enforcement power over alleged breaches of journalistic codes of ethics, provides the SEC with extensive authority to investigate and regulate the internal processes of the press. The potential for abuse of this power is a matter of substantial and legitimate concern to *amici*.

Amici are thus filing this brief to assist the Court by informing it of the broader concerns that are implicated by this particular prosecution.[1] *Amici* wish to emphasize, however, that they do not condone petitioner Winans' actions.

STATEMENT

A divided panel of the United States Court of Appeals for the Second Circuit has affirmed the conviction under the securities laws of a newspaper reporter who the government concedes had no fiduciary duty to any market participant and thus was a pure "outsider." Pet. App. 1a-29a. The court of appeals nonetheless held that Section 10(b) of the Securities Exchange Act, and Rule 10b-5 promulgated thereunder, were violated by the reporter when he "breached a duty of confidentiality to his employer by misappropriating from the [employer] confidential prepublication information, regarding the timing and content of certain newspaper columns" and used that information in purchasing and selling securities. Pet. App. 10a.

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[1] Pursuant to Rule 36 of the Rules of this Court, the parties have consented to the filing of this brief. Copies of those letters have been filed with the Clerk of the Court.

The case centers on the actions of petitioner Winans,[2] who from August 1982 to March 1984 authored the "Heard on the Street" ("Heard") column for the *Wall Street Journal* ("*Journal*"). The column consists of market gossip regarding notable volumes of trading in specific securities or price movements of various stocks. The Heard column did not rely upon or release any "inside" or confidential information, nor did the column purport to provide investment advice. However, the district court found that publication of the column had some unquantifiable impact on the prices of the securities that were the subject of a Heard column. Pet. App. 35a-36a.

Beginning in October 1983, petitioner Winans entered into an agreement with stockbroker Peter Brandt of Kidder, Peabody & Co., Inc. ("Kidder, Peabody"). Winans agreed to disclose the general tenor of comments—favorable or unfavorable—about specific securities and the probable publication date of upcoming columns in order to permit Brandt to trade in anticipation of the column's likely effect on the market price of the subject stocks. Winans never falsified or otherwise shaded the content or tenor of the column.[3] The agreement provided that profits, if any, were to be split between Winans, Brandt and petitioner Felis, another stockbroker at Kidder, Peabody, who assisted Brandt by executing many of the trades through his personal account.[4] Petitioners traded

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[2] The facts of the case are set forth in detail in the opinion of the district court, Pet. App. 33a-73a, and summarized by the court of appeals, Pet. App. 5a-7a. Because the securities fraud convictions of petitioners Felis and Carpenter are dependent on the conviction of petitioner Winans, *amici*'s legal analysis will focus on petitioner Winans' conduct.

[3] The agreement was based solely on the perceived value of prepublication access to the Heard column. Pet. App. 6a-7a.

[4] Petitioner Carpenter was not directly involved in the arrangement described. However, Winans made several small pre-

securities on the basis of information derived from the Heard column from October 1983 until March 1984, when Winans and Carpenter, in response to an investigation by the Securities Exchange Commission ("SEC"), voluntarily went to the SEC and testified concerning their activities. Pet. App. 7a.

The courts below found that Winans' trading in securities on the basis of his knowledge of the content and publication date of upcoming Heard columns violated the *Journal*'s internal conflict of interest rules. Specifically, the *Journal*'s conflict of interest rules provided that knowledge of forthcoming articles was "deemed" to be the "property" of the *Journal*. The *Journal*'s internal conflict of interest rules also prohibited employees from trading in securities if they knew that an article about the securities was forthcoming in the *Journal*. Winans believed (correctly) that disclosure of his agreement with Brandt and Felis would result in his dismissal from the *Journal*. Winans testified, however, that he did not believe that he was acting illegally. Pet. 7-8.

Following a bench trial, the district court held that petitioners Winans and Felis had entered into a conspiracy to violate the securities laws and that all three petitioners [5]—Winans, Felis and Carpenters—had violated Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. Pet. App. 3a-4a.[6]

The Second Circuit affirmed the securities law convictions under the government's theory that the petitioners had violated Section 10(b) and Rule 10b-5 by trad-

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publication trades in stocks discussed in the Heard column through a brokerage account he opened in Carpenter's name. The counts upon which Carpenter was convicted involved these unrelated securities trades. Pet. App. 38a-39a.

[5] Brandt had pleaded guilty in a separate action; he was the government's main witness at trial.

[6] Petitioners were also convicted on several counts of mail and wire fraud. *See* p. 18 n.17, *supra*.

ing on information that they had "misappropriated" from the *Journal* under the terms of the *Journal*'s conflict of interest rules. The court rejected the suggestion of *amici curiae* that such a broad theory of Rule 10b-5 liability would unnecessarily interfere with the editorial process of the print and broadcast media, thereby raising a potential First Amendment issue. The court stated that any restrictions on First Amendment protected activities "stem from the *Wall Street Journal* . . . company rules, not from any action by the government." Pet. App. 22a.

Judge Miner dissented. Pet. App. 27a-29a. He argued that the "misappropriation" theory, on which the majority relied, previously had been "applied only in those cases involving the taking and use of non-public, confidential, *securities-related information* by those who obtain that information *through special relationships* with their sources of knowledge." *Id.* 27a-28a (emphasis added). In this case, by contrast, "[n]o confidential securities information imparted by reason of any special relationship was purloined by these defendants." *Id.* According to Judge Miner, "[t]o say that the 'publication schedule' of the Wall Street Journal was the non-public, confidential information stolen by defendants is to extend the sweep of section 10(b) and rule 10b-5 beyond all reasonable bounds." *Id.* In essence, the theory adopted by the majority enlarged the "proscription of fraudulent and deceptive practices in connection with the purchase and sale of securities" under Rule 10b-5 into something Congress never intended—a means "to protect the reputation, or enforce the ethical standards, of a financial newspaper." *Id.* 29a.

In a separate SEC enforcement proceeding, petitioners entered into consent decrees pursuant to which they disgorged their profits from these securities trades, without admitting or denying the alleged securities law violations. 17 Sec. Reg. & L. Rep. (BNA) No. 42, at 1884 (Oct. 25, 1985).

SUMMARY OF ARGUMENT

In this criminal prosecution, the Second Circuit has adopted, for the first time, a major expansion of the prohibitions of Section 10(b) of the Securities Exchange Act. The Second Circuit has imposed the obligation to "disclose or refrain" from trading under Section 10(b) and Rule 10b-5 on a complete market outsider—a person with no "inside" information and no fiduciary obligation to any of the companies whose securities were traded. The convictions in this case were based not on a violation of any duty related to the securities markets, but rather on a violation of Petitioner Winans' duty to his employer, the *Wall Street Journal*, under the *Journal*'s code of ethics.

In affirming the convictions, the court below ignored the basic predicate of a Rule 10b-5 violation—that liability under the "disclose or refrain" doctrine must be based on the misuse of confidential information by one who has a clear *fiduciary obligation to the corporation whose shares are traded.* This premise of Rule 10b-5 liability, which has been consistently affirmed since the seminal *Cady, Roberts* decision of the SEC, is supported by the basic purpose of Section 10(b), to protect market participants and thereby promote confidence in the securities markets.

The imposition of Rule 10b-5 liability in this case also improperly disregarded the teaching of this Court's decisions in *Chiarella* v. *United States*, 445 U.S. 222 (1980), and *Dirks* v. *SEC*, 463 U.S. 646 (1983). Both *Chiarella* and *Dirks* make clear that Section 10(b) is limited to correcting only those informational imbalances which result from a breach of fiduciary duty to a market participant.

The Second Circuit's unprecedented expansion of the disclose or refrain obligation is particularly troublesome because of the potential First Amendment issues raised by the application of Rule 10b-5 to journalistic codes of ethics. The vagueness and uncertainty of the Second Cir-

cuit's disclose or refrain obligation is exacerbated by the potential arbitrariness of the SEC's litigation strategy. This Court can fairly construe Section 10(b) to avoid constitutional problems, and should do so. *NLRB* v. *Catholic Bishop of Chicago*, 440 U.S. 490, 507 (1979).

ARGUMENT

As the Second Circuit recognized, the conviction in this case is based on a novel expansion of the misappropriation theory in which petitioners' convictions under the securities laws rest *solely* on a violation of Winans' ethical duty to his employer, the *Journal*. Thus, the *Journal*'s internal operating rules, which are designed to protect the *Journal*'s reputation,[7] have become the basis for a criminal violation of the securities laws. In the absence of the *Journal*'s conflict rules, petitioners would not be criminally liable under Section 10(b). Put another way, at other financial publications which do not have similar conflicts rules, reporters may engage in precisely the same conduct as Winans without fear of prosecution under the securities laws. This striking anomaly—and others like it[8]—show the government's jerry-built theory is far removed from anything contemplated by Congress. Congress did not intend criminal liability to be predicated on private codes of conduct of non-market participants.

Althought *amici* do not condone petitioner Winans' conduct, *amici* submit that the government's theory of this case, as adopted by the Second Circuit, is clearly beyond

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[7] The court stated that the "interest" protected under its theory was the reputational interest of the *Journal*, as reflected in its conflicts policy: "[the *Journal*'s] employees should be and are barred from destroying their employer's reputation by misappropriating their employer's informational property." Pet. App. 20a-21a.

[8] For example the "sources" who provided the "non-inside" information to Winans were free to trade on their knowledge of the upcoming publication of that material. Moreover, as the court of appeals recognized, the *Journal* itself would be free to trade on the content of the Heard column. Pet. App. 20a-21a.

the scope of Section 10(b). In any event, the government's theory raises First Amendment questions, which can be readily avoided if Section 10(b) is fairly construed to invalidate this prosecution. Accordingly, the judgment below must be reversed.

I. WINANS WAS A PURE "OUTSIDER" AND HIS BREACH OF THE ETHICAL DUTIES HE ALLEGEDLY OWED TO THE *WALL STREET JOURNAL* WAS NOT A VIOLATION OF SECTION 10(b) OF THE SECURITIES ACT.

A. The Duty To Disclose Or Refrain From Trading Does Not Apply To A Market Outsider With No Inside Information Of The Corporation Whose Shares Are Being Traded.

To understand *amici*'s concerns, it is important to recognize how far removed the theory of this case is from the core purpose of Rule 10b-5's traditional prohibitions. Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), prohibits the use "in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of" a Securities Exchange Commission rule. The Commission's Rule 10b-5, in turn, proscribes any act that "would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." 17 C.F.R. 240.10b-5 (1984).

There is little legislative history to aid in the construction of this admittedly broad statutory and regulatory language. See *Santa Fe Industries* v. *Green*, 430 U.S. 462, 473 n.13 (1977); *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 202 (1976). However, the general purpose of the Act is clear: Section 10(b) was designed to protect market participants from fraudulent practices and thereby promote confidence in the securities markets. See H.R. 1383, 73rd Cong., 2d Sess. (1934); S. Rep. No. 792, 73rd Cong., 2d Sess (1934); *Ernst & Ernst*, 425 U.S. at

194-95. Thus, the core purpose of the Act is to prohibit "fraud"—misleading statements of material fact in connection with the purchase or sale of securities. See, *e.g.*, *Marx* v. *Computer Sciences Corp.*, 507 F.2d 485 (9th Cir. 1974).

It is now well established that, in addition to misstatements of fact, silence when there is a duty to speak may also constitute "fraud" with the meaning of Rule 10b-5. The Securities Exchange Commission and the courts have long held that corporate insiders (*i.e.*, officers, directors, and majority shareholders) who are privy to corporate secrets may not trade in securities on the basis of "inside" information without prior disclosure of that information. See, *e.g.*, *Cady, Roberts & Co.*, 40 S.E.C. 907 (1961); *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); see also *Chiarella* v. *United States*, 445 U.S. at 230. The Commission has, therefore, developed the rule that insiders must: (a) disclose the corporate secrets to the other party to the transaction, so that the other party can make a fully informed decision whether or not to trade; or (b) refrain completely from trading in the affected securities. See *Cady, Roberts & Co.*, 40 S.E.C. 907 (1961); *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). This duty imposed on corporate insiders arises from the insider's state law fiduciary obligation to the corporation and its shareholders. *Cady, Roberts & Co.*, 40 S.E.C. at 911-912. See *Chiarella*, 445 U.S. at 227-30; *Dirks* v. *S.E.C.*, 463 U.S. 646, 660 (1983).

The Commission has expanded the insider trading doctrine of Rule 10b-5 to proscribe trading on "inside" information by individuals who are not themselves insiders but who knowingly and wrongfully obtain confidential information from an insider. See, *e.g.*, *Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 237 (2d Cir. 1974); *Ross* v. *Licht*, 263 F. Supp. 395, 410

(S.D.N.Y. 1967). These tippees "assume an insider's duty to the shareholders not because they receive inside information, but rather because it has been made available to them *improperly*." *Dirks*, 463 U.S. at 660; see *In re Investors Management Co.*, 44 S.E.C. 633, 650 (1971). Thus, the tippee's duty to disclose or refrain from the trading derives from the inside "tipper's" fiduciary duty to the corporation and its shareholders. *Dirks*, 463 U.S. at 66 n.20.[9]

The Second Circuit has allowed the further expansion of the "disclose or refrain" rule to prohibit trading by "extended insiders," *i.e.*, individuals such as financial printers,[10] investment bank employees[11] or law firm employees,[12] who in the normal course of their employment obtain inside information about confidential corporate affairs. This expansion of the insider trading prohibitions is based on the theory that such "extended insiders" "have entered into a special confidential relationship in

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[9] Commissioner Smith explained the basis for "tippee" liability in *Investors Management Co.*:

> [t]ippee responsibility must be related back to insider responsibility by a necessary finding that the tippee knew the information was given to him in breach of a duty by a person having a special relationship to the issuer not to disclose the information. . . ."

44 S.E.C. 633, 651 (1971) (concurring in result). Tippee liability has also been justified by the theory that a third person who knowingly receives confidential information from a fiduciary in violation of the fiduciary's obligation to his beneficiary holds such information in constructive trust for the beneficiary. *Dirks*, 463 U.S. at 660, n.20 *quoting* 3 L. Loss, *Securities Regulation* 1451 (2d ed. 1961).

[10] *SEC* v. *Materia*, 745 F.2d 197 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985).

[11] *United States* v. *Newman*, 664 F.2d 12 (2d Cir. 1981), *aff'd after remand*, 722 F.2d 729 (2d Cir.), *cert. denied*, 464 U.S. 863 (1983).

[12] *SEC* v. *Musella*, 578 F. Supp. 425 (S.D.N.Y. 1984).

the conduct of the business of the [corporation] and are given access to information solely for corporate purposes." *Dirks*, 463 U.S. at 655 n.14. Use of the confidential information so acquired for private gain, without disclosure, constitutes "misappropriation" of that information in violation of the extended insider's fiduciary duty to the corporation and its shareholders.

While the duty to disclose or refrain under Rule 10b-5 has expanded over the years, it has, until this case, remained anchored to its central premise—that liability for "insider trading" results from the misuse of confidential corporate information by one who has a clear fiduciary obligation to the corporation whose shares are traded.[13] That premise has been the basis of the disclose or refrain doctrine since the seminal *Cady, Roberts* decision, in which the "Commission emphasized that the duty [to disclose or refrain] arose from (i) the existence of a relationship affording access to inside information . . . and (ii) the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure." *Chiarella*, 445 U.S. at 227, *citing Cady, Roberts*, at 912 & n.15.

It is because there is a duty to the corporation whose securities are being traded that the fraud is "in connection with" the purchase or sale of securities within meaning of the statute. Without that limitation, the statute

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[13] In the case of the corporate insider, the basis for the fiduciary duty is based on the common law duty to avoid self-dealing. *See* Cady, Roberts, 40 S.E.C. at 911 & n.13. The tippee "assumes a fiduciary duty to the shareholders of a corporation . . . only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach." *Dirks*, 463 U.S. at 660. An "extended insider," such as an attorney or investment banker, acquires a fiduciary duty to the shareholders on the basis of his "special confidential relationship" to the corporation and the corporation's expectation, whether or not expressed, that he will keep the non-public information confidential. *Id.* at 655 n.14.

could be extended to situations where a wrongdoer engages in fraud to obtain money and then uses the money to purchase securities. While that conduct is surely wrong, Congress clearly did not intend to authorize the SEC to investigate and regulate any ordinary fraud simply because the proceeds may have been converted into securities.[14]

The government's theory in this case is not materially different from this hypothetical. Instead of taking someone else's money and trading in the market, Winans took the *Wall Street Journal*'s publication schedule for the Heard column and traded in the market. It must be stressed that *in this case*, the government alleged and proved harm only to the *Journal* and not to any buyer or seller of stock. Pet. App. 18a, 20a-21a.

The fundamental flaw with this application of the misappropriation theory is the complete absence of any link between Winans and the corporations whose securities were traded. Winans is a complete market outsider. Under the long-established premise of Rule 10b-5 liability, Winans simply had no duty to disclose because he had *no fiduciary obligation*, through employment or other relationship, with the corporations whose shares were traded.

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[14] Congress could determine, for policy reasons, to broaden the scope of Section 10(b)'s "disclose or refrain" obligation to further other legitimate purposes, such as the protection of the *Journal*'s reputation. However, the government has not, and cannot, point to any legislative history suggesting that Congress intended that the current securities laws would be used to "protect" private reputations. It is also clear that Congress never intended Section 10(b) to establish a "general duty between all participants in market transactions to forgo actions based on material nonpublic information." *Chiarella*, 445 U.S. at 233. In fact, the securities laws *allow* certain forms of trading on nonpublic market sensitive information. *See, e.g.*, 15 U.S.C. § 78m(d)(1) (allowing tender offer or to purchase up to 5% of target stock prior to disclosure of acquisition).

Moreover, unless the element of fiduciary obligation is linked to a market participant, the *only* limiting principle of the "disclose or refrain" doctrine will be eliminated. If the Court does not draw the line here, the "significant distinction" between legal obligations and ethical ideals will be erased,[15] and the federal government will be free to seek criminal sanctions for any trading in securities relating in any way to violations of private standards of conduct and ethics.

B. The Government's Misappropriation Theory As Applied In This Case Clearly Conflicts With The Prior Decisions Of This Court.

In applying Rule 10b-5 to a complete market outsider who had no access to any "inside" information and who owed no fiduciary duty to any companies whose securities he traded, the Second Circuit not only could find no support in the purpose and history of Section 10(b) but it also improperly disregarded this Court's decision in *Chiarella* v. *United States*, 445 U.S. 222 (1980), and *Dirks* v. *SEC*, 463 U.S. 646 (1983).

1. In *Chiarella* v. *United States*, this Court reversed the conviction under Section 10(b) of a financial printer who had traded on the basis of his advance knowledge of takeover bids. The Court held that liability for failure to disclose such information prior to trading in securities can only be imposed where there is a "duty to disclose arising from a relationship of trust and confidence between parties to a transaction." *Chiarella*, 445 U.S. at 230. The conviction was reversed because the "Court of Appeals, like the trial court, failed to identify a relationship between [Chiarella] and the sellers that could give rise to a duty." *Id.* at 231-236.[16] Instead, in

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[15] *See Dirks*, 463 U.S. at 661 n.21 (*quoting* SEC, Report of Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 1, pp. 237-238 (1963)).

[16] The Court left open the question whether Chiarella could have been convicted on the theory that his misappropriation of the

Chiarella, the court of appeals had relied on a "parity of information" theory under which persons like Chiarella, who have access to confidential information, may be restrained from trading, absent disclosure, to avoid "unfair advantage over less informed buyers and sellers." *Id.* at 232.

This Court found that reasoning defective in two respects. First, "not every instance of financial unfairness constitutes fraudulent activity under § 10(b)." *Id.*, (*citing Santa Fe Industries* v. *Green*, 430 U.S. 462, 474-77 (1977)). Second, the "element required to make silence fraudulent—a duty to disclose—[was] absent in [Chiarella's] case." *Id.* With respect to Chiarella's obligation to the shareholders from whom he purchased the securities at issue the Court noted:

> He was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence. He was, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions.

Id. at 232-33.

Finally, the Court noted that any judicial adoption of a broad duty of disclosure that departed radically from the traditional basis of such duties in fiduciary relationships "should not be undertaken absent some explicit evidence of congressional intent." *Id.* at 233. The Court left open the issue of whether a broader reading of obligations under Section 10(b) might raise questions of whether potential defendants had been given fair notice of the criminality of their acts. *Id.* at 235 n.20 (*citing*

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information on which he based his trading breached a duty to his employer, the printing company, which, in turn, owed a duty to the acquiring company in the takeover bid. Even assuming that this version of "misappropriation" theory were adopted under the rubric of "extended insider," the *Journal*—unlike the printing company in *Chiarella*—owed no duty to the companies whose stock was traded by petitioners.

Grayned v. *City of Rockford*, 408 U.S. 104, 108-109 (1972)).

2. In *Dirks*, this Court reiterated its careful interpretation of the Rule 10b-5 duty to "disclose or refrain." In that case, Dirks, a broker-dealer, received nonpublic information that the assets of a corporation, Equity Funding, were "vastly overstated." Based on this information Dirks recommended to some of his clients that they sell their Equity Funding shares. It was undisputed that Dirks had access to information—from the officers and employees of the corporation—that was not generally available to the market. It was also undisputed that Dirks' clients benefited from trading on that non-public information. On the basis of these facts, the SEC censured Dirks for aiding and abetting a violation of Rule 10b-5. This Court reversed, holding that Dirks "had no duty to abstain from use of the inside information that he obtained." *Dirks* 463 U.S. at 667.

Although Dirks received confidential information from Equity Funding insiders, "[i]t is clear that . . . [no] Equity Funding employees violated their *Cady, Roberts* duty to the corporation's shareholders by providing information to Dirks." *Id.* at 666 (footnote omitted). "In the absence of a breach of duty to shareholder by the insiders, there was no derivative breach by Dirks." *Id.* at 667.

In holding that Dirks, as a stranger to Equity Funding and its shareholders, could not be held liable directly for breaching Rule 10b-5, this Court ruled that "there can be no duty to disclose where the person who has traded on inside information 'was not [the corporation's] agent, . . . was not a fiduciary [of the corporation, and] was not a person in whom the sellers [of the securities] had placed their trust and confidence.'" *Id.* at 654, *quoting Chiarella*, 445 U.S. at 232.

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Thus, both the history of Rule 10b-5 and the holdings of this Court require that, in cases of failure to disclose information, the scope of Rule 10b-5 should be limited to situations where there is a breach of a *fiduciary duty* to the corporation whose securities have been traded or to its shareholders.[17] Certainly, the securities laws should only correct those informational imbalances caused by breaches of some duty owed to a *market participant*. Without such a nexus, the reach of Rule 10b-5 is virtually limitless and can be used to criminalize virtually any unethical practice which has some relationship to the securities markets. Indeed, the government has offered no limiting principle for its theory other than its own good faith.

It is neither necessary nor appropriate for the SEC to attempt to ferret out all breaches of duty to all employers simply because an employee's misconduct bears some connection to a securities transaction. Such matters can and should be handled by self-policing mechanisms within the industry. Newspapers ordinarily can uncover ethical violations and take appropriate action without the intervention of the SEC.[18] The availability of private and state law alternatives to the federal securities laws argues forcefully for limiting the scope of Rule

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[17] *Amici* will not address the various issues under the mail and wire fraud statutes raised by petitioners in this case. However, to the extent that the "fraud" claim is based solely on Winans' "failure to disclose to his employer (the *Wall Street Journal*) that he had breached the *Journal's* private rules of confidentiality . . ." *see* Pet. 18, *amici* submit that a holding which permits the government to enforce an obligation to disclose or refrain from trading under the mail and wire fraud statutes affects the First Amendment rights of *amici* just as much as enforcement of similar requirements under the securities laws. *See* pp. 20-25, *infra*.

[18] If the Commission believes that a *federal* judicial remedy is necessary in the circumstances of this case, it should seek to have such a remedy created by Congress. But it should not attempt to have such a remedy "supplied by judicial extension of § 10(b) and Rule 10b-5 to 'cover the corporate universe.'" *Santa Fe Industries* v. *Green*, 430 U.S. 462, 480 (1977) (footnote omitted).

10b-5, especially where the Congress has not spoken. *Santa Fe Industries* v. *Green*, 430 U.S. 462, 478-479 (1977) (rejecting an interpretation of Rule 10b-5 that would "bring within the Rule a wide variety of corporate conduct traditionally left to state regulation"); *Piper* v. *Chris-Craft Industries*, 430 U.S. 1, 40-41 (1977). See also Pet. App. 10a n.5 & 21a n.11.

In sum, this Court should hold that the government's theory of criminal liability under Rule 10b-5 is not authorized by the Congress and is in conflict with the decisions of this Court.

II. THE COURT SHOULD CONSTRUE SECTION 10(b) TO AVOID SUBSTANTIAL CONSTITUTIONAL QUESTIONS.

The government's unprecedented attempt in this case to expand the "disclose or refrain" obligations is particularly troublesome because of its potential effect on the editorial processes of the print and broadcast media protected by the First Amendment. Two factors combine to create First Amendment problems: the vagueness and uncertainty of the application of Rule 10b-5 to journalistic codes of ethics and the potential arbitrariness of the SEC's litigation strategy, which this Court has commented upon in the past. Together, these factors threaten infringement of First Amendment rights. Accordingly, this Court should narrowly construe Section 10(b) to avoid such constitutional problems. *NLRB* v. *Catholic Bishop of Chicago*, 440 U.S. 490, 507 (1979). Because the government's theory is so far from the core of Section 10(b) and so contrary to the purpose of the nondisclosure rules of Rule 10b-5, such a construction is surely a fair one.

Under the government's theory of the case, the government is now authorized to regulate aspects of the reporter-editor relationship by enforcing vague ethical obligations of a reporter to his employer if their breach may affect

securities trading—obligations which will vary with the particular code of ethics adopted by particular media organizations. Such codes of ethics are not written like criminal statutes, and their violations are not intended to result in criminal sanctions. They were not written to create complex issues of criminal liability under the securities laws for publishers, editors and reporters.

Amici's concern with the potential scope of the government's theory of the Rule 10b-5 liability can be readily illustrated by a realistic hypothetical. A reporter obtains non-public information, which does not derive from "inside" sources, that XYZ corporation has made a big oil find. He plans to use that "non-inside" information in an article for his paper. The reporter needs, however, additional sources to confirm the story. Although the newspaper has a policy against disclosing information which might be used for stock market trading, the reporter contacts an expert geologist, who has not heard about the oil find, but knows how to obtain confirmation. The reporter knows from past experience that the expert may seek to trade on the basis of such information. The expert obtains confirmation of the find and then buys XYZ's stock, knowing that the price will rise sharply after the story is published. The expert then calls back the reporter, reports his findings and tells him that he purchased stock in XYZ company. Under the government's theory as applied by the courts below, the reporter may be liable under the securities laws because he has used the newspaper's information, which when published will affect the market, to obtain a benefit (confirmation of an important story) in arguable breach of the employer's ethical code.[19] In addition, the editor may be liable for aiding and abetting the breach if he publishes the story. In these circumstances,

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[19] The benefit derived by the tipping party need not be an immediate financial gain in order to create liability under Rule 10b-5. *See Dirks*, 463 U.S. at 663-664.

neither the reporter nor the editor will know how to proceed. Of course, without the use of the expert's confirming statements, the reporter might not even have a publishable story.

1. This Court has previously recognized that the editorial process, which includes the relationship and communications between reporters and editors, is constitutionally protected from "casual inquiry" by the federal government. See *Herbert* v. *Lando*, 441 U.S. 153, 174 (1979); *Richmond Newspapers, Inc.* v. *Virginia*, 448 U.S. 555, 576 (1980) (plurality opinion); *First National Bank of Boston* v. *Bellotti*, 435 U.S. 765 (1978). The government's effort, sanctioned by the Second Circuit, to impose an uncertain "disclose or refrain" obligation on reporters based on violations of journalistic codes of ethics directly interferes with this process by dictating without specificity that reporters must make some disclosures to their editors.

The disclosures required by the government's theory also will affect editors making the decision whether an article should be published because publication is a critical element of the securities fraud. Under the government's theory, if the reporter discloses prior trading to his editor, the editor's decision to proceed with publication might be held to constitute aiding and abetting the violation of the securities law. See *IIT* v. *Cornfeld*, 619 F.2d 909 (2d Cir. 1980). Thus, the application of the "disclose or refrain" rule in the media context implicates a central concern of the First Amendment—the prohibition against restraints on publication. See, *e.g.*, *Miami Herald Publishing Co.* v. *Tornillo*, 418 U.S. 241, 254-255 (1974); *CBS* v. *Democratic National Comm.*, 412 U.S. 94, 117 (1973) (plurality opinion); *Near* v. *Minnesota*, 283 U.S. 697 (1931).

Moreover, because the disclosure requirement is derived from an inherently vague anti-fraud rule *and* from inherently vague codes of journalistic ethics (not promul-

gated for the purpose of defining crimes), there is a potential that *amici* and their members will be chilled in their communications and decisions as to what to write or publish due to the threat of civil or criminal sanctions.[20] By authorizing the federal government to push Rule 10b-5 beyond the board rooms and into the news rooms, the court below has opened a door for potential governmental abuse. The financial press is now subject to routine governmental scrutiny for possible breaches of the newspapers' work rules that may have affected some securities transaction to benefit a reporter in some way. Doubtless sensitive to the obvious problem for the press created by the unwarranted extension of Rule 10b-5, the SEC has publicly eschewed any intent to overreach in its enforcement efforts against the print and broadcast media.[21] But this Court has recognized expressly that reliance on the "reasonableness of the SEC's litigation strategy . . . . [is] hazardous" at best. *Dirks* v. *SEC*, 463 U.S. at 664 n.24. The very existence of this authority, which is inherently susceptible to abuse for political reasons, coupled with this Court's own doubts about the

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[20] As in *Dirks*, the rule developed in this case is "inherently imprecise, and imprecision prevents parties from ordering their actions in accord with legal requirements." *Dirks*, 463 U.S. at 658 n.17. Thus, even absent First Amendment concerns, the Second Circuit's holding that "certain undefined activities" may be prohibited by Section 10(b)—depending on internal codes of ethics—"raise[s] questions whether either criminal or civil defendants would be given fair notice that they have engaged in illegal activity." *Chiarella*, 445 U.S. at 235 n.20. The fact that the prosecution in this case does implicate First Amendment concerns requires that the line between ethical requirements and criminal violations be drawn with even greater clarity.

[21] In a speech given soon after this case began, the Enforcement Director of the SEC stated that the Commission "does not intend to inject itself into the editorial judgments reporters must make." BNA, *Daily Report for Executives* p. A-5 (Oct. 24, 1984). But it is unquestionably true that the very presence of Rule 10b-5 can affect editorial judgments by injecting a new concern into basic editorial decisions.

future reasonableness of the SEC's litigation practices, threatens infringement of First Amendment rights.

2. If the Court finds that the theory of Rule 10b-5 liability adopted by the court below does constitute an infringement of First Amendment rights, then this prosecution can only be upheld if it is necessary to serve a government interest of the highest order. See, *e.g.*, *NAACP* v. *Button*, 371 U.S. 415, 438 (1963); *Smith* v. *Daily Mail Publishing Co.*, 443 U.S. 97 (1979). Here, the government has not even attempted to make a showing that there is any substantial government interest to support this intrusion into the editorial process. Nothing in the legislative history suggests *any* Congressional interest in using the securities law to protect the reputation of a financial newspaper when there is no alleged or proven injury to a market participant.

Instead of addressing *amici*'s First Amendment contentions directly, the Second Circuit sidestepped the constitutional issue by arguing that the "restrictions stem from the *Wall Street Journal* . . . rules, not from any action by the government." Pet. App. 22a. This logic is totally specious. There is a vast difference between private enforcement of internal ethical guidelines and federal criminal prosecutions. The government is engaged in the unprecedented practice of using existing internal codes of ethics to "make" criminal cases. Moreover, the government's theory results in irrational outcomes, *e.g.*, a reporter in a news organization without formal ethical rules may engage in conduct identical to Winans' without being subject to prosecution and a publisher may trade with impunity on knowledge about forthcoming stories even though a reporter may face federal criminal charges if he does so. The fact that the government's theory of this case is riddled with irrationality indicates that the government's interest is exceedingly weak and cannot sustain the infringement created by the rule.

3. Even if the Court finds that the prosecution in this case does not present a sufficient threat to First Amendment's interest to trigger the "compelling government interest" standard, there is nevertheless reason to weigh the potential First Amendment interest in the balance in the Court's consideration of the proper scope of Section 10(b). As *amici* have demonstrated, pp. 20-23, *supra*, the vagueness and uncertainty created by the government's theory, coupled with doubts about the reasonableness of the SEC's enforcement policy, provide a basis for serious concern about the impact of the government's theory of Rule 10b-5 liability on *amici* and the print and broadcast media they represent.

It is a well-established principle that the courts will construe statutes to avoid constitutional issues where such a construction is fair and reasonable. See, *e.g.*, *Lowe* v. *SEC*, 472 U.S. 181, 190 & n.24 (1985); *NLRB* v. *Catholic Bishop of Chicago*, 440 U.S. 490, 507 (1979). Here, the construction of Section 10(b) espoused by *amici* clearly is a fair reading of the statute. Indeed, in this case, it is the government's interpretation of the scope of Section 10(b) that is unreasonable and outside the legitimate concerns of the Congress.

Finally, the government's prosecution of this case, which for the first time incorporates violations of journalistic codes of ethics into the federal criminal code, disregards the well-established rule that "ambiguity concerning the ambit of criminal statutes should be resolved in favor of lenity." *Rewis* v. *United States*, 401 U.S. 808, 812 (1971), *citing Bell* v. *United States*, 349 U.S. 81, 83 (1955). As noted previously, *amici* are unanimous in this condemnation of Winans' conduct. It is far from clear, however, that a federal criminal prosecution in these circumstances is necessary to protect either the securities markets or financial journalism. In sum, the government's theory, at best, is tenuously linked to the purposes of the securities laws and constitutes a potential threat to the industry it was designed to "protect." Ac-

cordingly, the Court should reject the expansion of Section 10(b) esopused by the government and reaffirm the established basis of Section 10(b) liability as set forth in *Chiarella* and *Dirks*.

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Such a construction should have no impact on prosecutions growing out of the recent and wide-spread abuse of genuine "inside" trading on Wall Street. The unprecedented and anomalous prosecution in petitioner Winans case involves a pure "outsider" whom Congress never intended to reach when it enacted Section 10(b). Given the broad scandal regarding genuine "insider" trading which is now sweeping Wall Street, Congress will be taking a serious look at defining, through new statutory language, the circumstances under which non-disclosure of confidential information violates the securities law. Given the broad implications of making non-disclosure by an "outsider" a violation of federal law, it should be a task for the Congress, not for the SEC or a United States Attorney, to determine whether such a rule is necessary or appropriate.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted,

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